

District Director
Brooklyn, New York

JAN 3 1991

Assistant Chief Counsel
(Passthroughs and Special Industries)

[REDACTED]
(Taxpayer)
TR-45-1251-90

Please find enclosed your administrative file regarding Taxpayer's application for exempt status under section 521 of the Internal Revenue Code. After reviewing the administrative file and your letter to Taxpayer, we believe that the requirements for exempt status have not been met. Stated below is our opinion why we do not believe Taxpayer is entitled to receive the aforementioned exemption.

In Puget Sound Plywood, Inc. v. Commissioner, 44 T.C. 309 (1965), acq., 1966-1 C.B. 3, three principles are described as fundamental to cooperative operations: (1) subordination of capital; (2) democratic control; and (3) operation at cost. We believe that the principle of operation at cost may be subdivided into three separate concepts: (1) A pre-existing legal obligation; (2) equitable allocation; and (3) an annual allocation of net patronage earnings. It is well established that in order to operate at cost a cooperative must be under a pre-existing legal obligation to return to its patrons all margins or profits from business transacted by the cooperative on behalf of the patrons. As the court in American Box Shoot Export Association v. Commissioner, 4 T.C. 758 (1945), aff'd., 156 F. 2d 629 (9th Cir. 1946) stated:

In order to be a true cooperative, there must be a legal obligation on the part of the association to return to the producers, on a patronage basis, all funds received in excess of the cost of the goods sold. Such an obligation may arise from the association's articles of incorporation, its bylaws, or some other contract. 4 T.C. 758, 761.

08836

Conversely, if a cooperative's board of directors is not legally obligated to return net margins to its patrons and has the discretion to divert net margins without allocating such margins to its patrons, we believe the cooperative will breach its pre-existing legal obligation. As a result, if a cooperative does not have a pre-existing legal obligation to return net margins to its patrons, the cooperative will not satisfy the fundamental cooperative principle of operation at cost, and, therefore, will not be operating on a cooperative basis.

Based upon the above law, we believe the Taxpayer's bylaws should explicitly state that, "the corporation is obligated to distribute the net proceeds from business with or for its member and nonmember patrons in proportion to the business with or for such patrons."

After considering our recommendations and conclusions, it will not be necessary to return the file to our office.

PAUL F. KUGLER
Assistant Chief Counsel

(signed) Susan J. Reaman

By:

SUSAN REAMAN
Assistant Chief, Branch No. 5
Office of Assistant
Chief Counsel
(Passthroughs and Special
Industries)

Attachments:

Copy of this memorandum
Administrative file